RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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July 13, 1988 **LETTER 995**

July 1 DJIA 2131.58; PTI 2737; A-D Ratio -8.69
July 8 DJIA 2106.15; PTI 2737; A-D Ratio -9.02
Current Dow yield: 3.55%; Dow P/E: 14.6
Dow 200-day mov aver: 2035; DowPow: 955

THE MARKET: I didn't make it clear enough in recent Letters. When the Transports (on June 30) rallied to close above 904.12, I received about two dozen calls from subscribers asking me if this was the "signal to buy."

Since there is some confusion, I am going to go into the whole matter of bear markets and bear market strategy again -- in detail. First, there are two intelligent and legitimate ways to operate in the market. The first is as an experienced, sophisticated trader. The trader plays the near-term in any of a thousand different ways. Personally, I don't know of any better way to do this than with my Primary Trend Index (PTI). I've often written that anyone can trade with the PTI -- "All you have know is up from down." When the PTI is above its moving average (MA) you buy, and when the PTI drops below its MA you get out. It's as simple as that, and many of my subscribers follow this method. The PTI (see page 2 chart) rallied above its MA in mid-January; it's been there ever since. Problem: You can get whipsawed.

The second method is investing with the great primary trend of the market. When it's a bull market, you're fully invested. When it's a bear market you're out, on the sidelines, patiently awaiting "great stock values" and the next bull market.

As for the Averages and the action of the market, once a bear market is signaled, the long-term (or primary trend) investor exercises patience. This is the great "secret ingredient" in successful long-term investing. It's the way most investors make real fortunes in the stock market. They invest with the primary trend, they stick with the primary trend -- and they are patient, very, very patient.

Next, what do "upside confirmations" in the Averages mean during a bear market? First, upside confirmations tend to mean higher prices in any kind of market. But the caveat is that upside confirmations in primary bear markets do not have the authority they have in primary bull markets. Thus, upside confirmations in bear markets may lead to higher prices, but they are also frequently deceptive (many upside confirmations in bear markets are simply devices by which the bear lures in additional buyers).

But here's the main point that I want to get across to the majority of my subscribers, who tend to be long-term investors rather than traders. We don't buy stocks in bear markets, no matter what the market does. When upside breakouts occur (and, of course, they will occur) we let the other guy do the buying. We remain on the sidelines and let the other guy make the killing. Playing bear market rallies (in my experience) is just too dangerous and nerve-rattling for the average investor. And when a bear rally runs out, the downside can be rapid, violent, and costly.

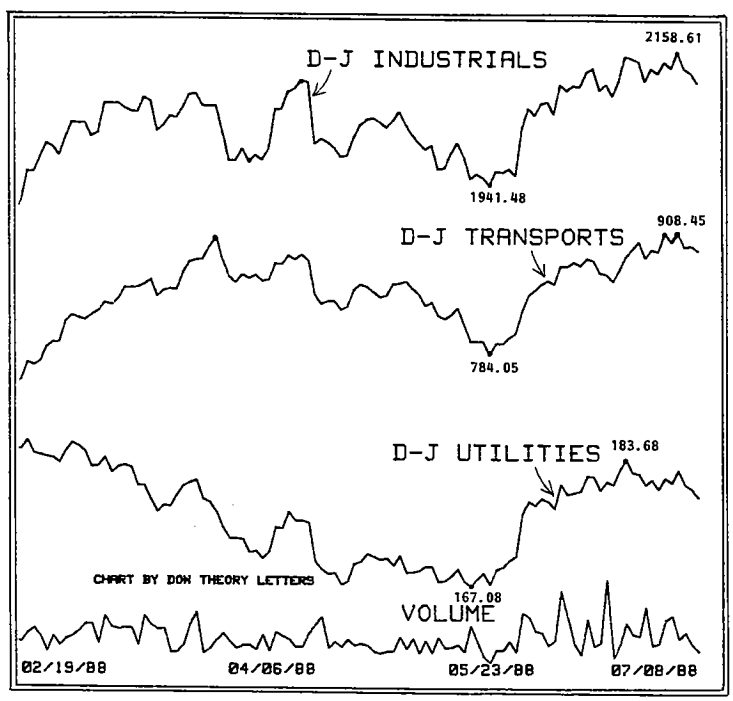
PRIMARY TREND: The concept of the primary trend of the market is the most basic and important concept in investing. Yet it is the one that I find most difficult to get across to investors. I know because I've been writing these Letters for 30 years, and I've met few, very few, investors (and I include most professionals) who really understand the meaning of the primary trend.

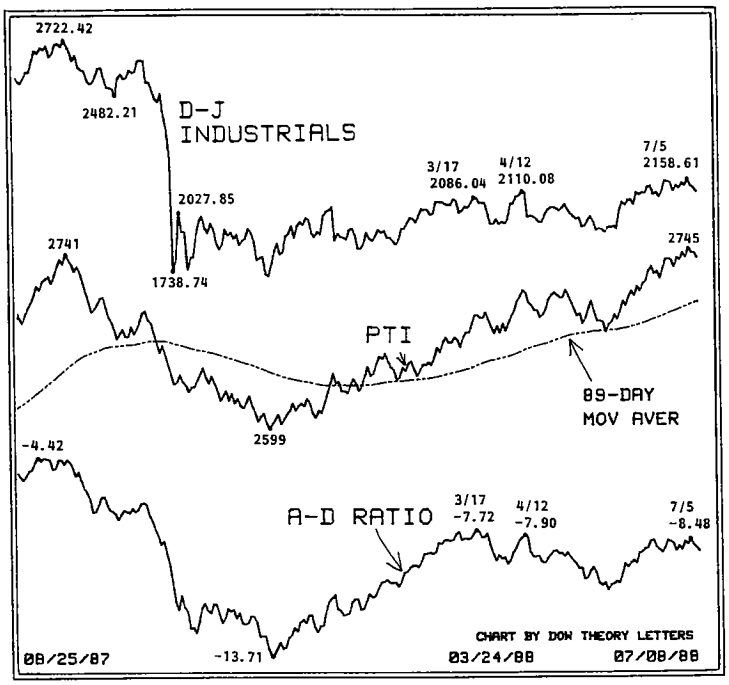
But I insist that my subscribers understand it, so here goes. Picture yourself at the seashore. You've been trying to identify the direction of the tide. You've been watching the waves and it's confusing, to say the least. Then you have an idea. You place a twig at a point where a particularly powerful wave finally ends -- at the point where the last ripple of water sinks into the sand. The next wave ends within inches of the twig, but it doesn't quite touch the twig. Then the next few waves pass the twig, so you move the twig to where the most powerful of the new waves ends.

Next, a succession of waves arrive, but none go past your twig. During the next hour the waves recede, and you're sure that the tide is running out. Then a surprise -- a particularly strong wave comes along (comparable to a secondary reaction in the stock market). This powerful wave ends only a few feet from your twig. You wonder, is the tide really going out? Or was this just a single erratic wave? But it soon becomes clear that your twig was really planted at the high-water mark. After that single powerful wave, subsequent waves recede noticeably, never nearing your twig again. At this point, you know without a shadow of a doubt that the tide is indeed running out, and you also know that the next major seaside event will be low tide. You decide that you will return later in the day to use the same twig-placement technique in order to identify the extreme low tide.

The very same identification techniques apply to the stock market. Once the high for a bull market has been recorded, the tide will be running out, and a bear market will take over. True, you may get strong (counter-trend) secondary reactions. And a few of these upward corrections may be so strong that you will be convinced that the bull market has been "resurrected." But the market (i.e., the stock averages) will not surpass the old highs. And as each upward correction burns itself out, the primary trend will inevitably reassert itself, and the market will head down again.

Read any investment letter. Read any newspaper. Read any financial magazine. Read any brokerage house report. Read them carefully





and see if they talk about or even mention the primary trend of the market. If they do talk about trends (and most of them do), they will invariably focus on what the market may do next week or next month or they will report on some analyst's "target" for the Dow or what will have to happen in the economy to "revive the bull market again."

In other words, they just don't understand the basic concept of the primary trend. They don't understand that as far as the primary trend concept is concerned, it doesn't matter whether the Dow now rallies to 2300 or 2400 or 2500, it doesn't matter if the Transports now rally to 1000. It doesn't matter if the S&P rallies 10% from here, and it doesn't matter whether George Bush or Michael Dukakis or Jesse Jackson or Michael Jackson is our next President.

Here's what does matter. On August 14, 1987 the D-J Transportation Average recorded a bull market high of **1101.16.** A few weeks later, on August 25, the D-J Industrial Average recorded a bull market high of **2722.42**. Those *joint peaks marked the high water mark, the tidal top for the great bull market.* They are the twigs that we placed at the stock market's high water mark.

Those historic August highs in the Averages were accompanied by every characteristic of a third phase bull market top, from minuscule stock yields to extreme overvaluation in stocks, from rampant speculation to surging NYSE volume, from explosions in low-priced issues to an almost univeral obsession with "Dow 3600" and beyond.

The August 1987 highs in the Averages were followed by a classic bear market signal (October 15) and then by the worst crash (October 19) in stock market history. If there were ever classic indications of the death of a bull, we witnessed them last year in the August-October period. I never saw a clearer and more obvious top, and I said so at the time, many times over.

So what does it really mean when we talk about "the death of the bull?" What does it mean when we say "the primary trend has reversed and the great bull market of 1974-87 is over"? It means that the stock market in August 1987 discounted the best, the very best, that could be seen ahead. And when the best has been discounted the market can only deteriorate. Lest you're still confused, here's what the turn in the tide doesn't mean. It doesn't mean that we can't have rallies from here, it doesn't mean that the October crash lows won't hold for another month or another six months or even another year. It doesn't mean that the Industrial Average alone or the Transports alone can't rally to a new high (doubtful but possible). But it does mean that the joint highs (i.e., the highs for the Dow and the Transports and most stocks) for this bull market have been recorded.

Now true, "the stock market can do anything." It can fool us, it can play with our minds and our wallets, it can drive us up the wall. Both the bull and the bear can do any of those things. And this post-crash rally can extend, it can re-kindle hopes, it can turn the majority bullish again. It can even take selected stocks and stock groups to new highs above last year's bull market highs (for example, in 1930, a year after the '29 crash, the motion picture stocks rallied to new all-time highs).

But the much more important picture is that the great 1974-87 bull market is OVER. For the majority of stocks, for the majority of stock groups, for most of the major stock averages -- it's OVER.

We're now in the first phase of a primary bear market. True, the bull of 1974-87 is dead, but the bear market isn't just going to sink relentlessly to Dow 1500 or 1000 or 800. Hardly. What I think we're going to see is as follows -- slowly, erratically, probably over a period of a few years or longer, this market is going to sink, stumble, rally, but ultimately decline. Before it's all over, as the bear breathes his last, stocks are going to be on the bargain counter again. Wall Street, having worn out the believers, the optimists, the perpetual bulls, is going to be a dirty word. Those advisors who are still around near the bear market's end will be telling you why "stocks are finished," and why "Wall Street will never rise from the ashes again."

And of course, that will be "accumulation time" for Dow Theorists. That will be "turn of the tide time" for serious investors. That will be the area where the bear market has discounted the worst that can be seen ahead. But the turn, when it arrives, will be as difficult to identify as the reversal from the top was last August. That's the way of the market. That's the way of Wall Street. It's the toughest game in the world, and you have to love it to survive in it.

All right, I want to present a final concept in this long-winded primary trend piece. It is this: **Bull signals are only valid when they occur at the end of the third phase of a bear market.** In other words, the bear market must go through its three phases before we can start looking for the mechanical formation that will signal a new primary bull market.

Again, what are the three phases of a bear market? The first phase (we are now in it) is the phase where the market goes down (sometimes it crashes) in the face of a still prospering economy. In this initial phase the stock market wipes out the froth, hysteria, and overvaluation which existed at the preceding bull market top. Remember, business is still good during the first phase of a bear market, but during the first phase, stocks will often stop responding to good news, and this is a hint worth remembering. In the first phase, the public usually halts its buying of stocks (although they will probably not be leaving the market yet).

The second phase of the bear market is the one in which stocks go down in response to obviously deteriorating business conditions and declining corporate earnings. This is usually the longest and most deceptive phase (it can be punctuated with many violent secondary corrections). During the second phase the public will be leaving the market in droves.

The third and final phase of a bear market is the liquidation phase. This phase is usually accompanied by dreadful business news and collapsing corporate earnings. Investors' sentiment turns black in this phase, and boardrooms are deserted. This is the phase where good stocks (the blue-chips) are dumped if only to raise cash for desperate investors. It is here (remember 1974?) when analysts are openly predicting "the end of the stock market and the end of Wall Street as we know it."

Now it is also in this third-phase area that we can start looking for the ultimate bear market bottom. Volume will be low, the news will be awful, stock yields will be high. But another phenomenon will be seen. Stocks will have stopped going down in the face of bad

news. The market has become immune to disaster. Next, a strange phenomenon: the Averages, will rally, then decline drastically, then mysteriously rally again, but on the second rally the preceding highs will be surpassed (by both Industrials and Transports).

This is it. This is the real McCoy. This is a bull signal coming in the face of black depression, it is a bull signal that no one believes if, indeed, they have even noticed it. This is a bull signal coming after the third phase of a bear market. This is a true bull signal. A new bull market has begun.

TRADING PLACES: Yes, the US has traded places. We've traded our position as the world's biggest creditor to become the world's biggest debtor. The tragic story is that we're selling off our equities, our corporations, our real estate and our debt, piece by piece, in order to keep up the spendthrift American standard of living. How does it work? Easy, month after month we spend more than we take in, then we borrow the difference (much of it) from foreigners. Foreigners then take their increasing income (income from profits and trade surplus) and buy up US real estate, corporations, stocks, and bonds.

All of which generates even more profits for our foreign creditors while reducing US income, and the beat goes on. President Reagan says we're in great shape. If we weren't, he says, why would foreigners be so willing to buy us up? Mr. Reagan probably even likes this little squib from last week's *USA Today*. But I don't like it; and I think that curing this chronic problem may be what this bear market is going to be all about.

DEBT GROWS 36%: The USA's foreign debt soared to $368.2 billion in 1987 as the USA lengthened its lead as the world's largest debtor nation. The new debt burden was 36.8% higher than a revised $269.2 billion debt to foreigners that the USA was carrying at year-end 1986. Simply put, the U.S. debt means that foreigners now own more in U.S. assets than U.S. citizens own abroad.

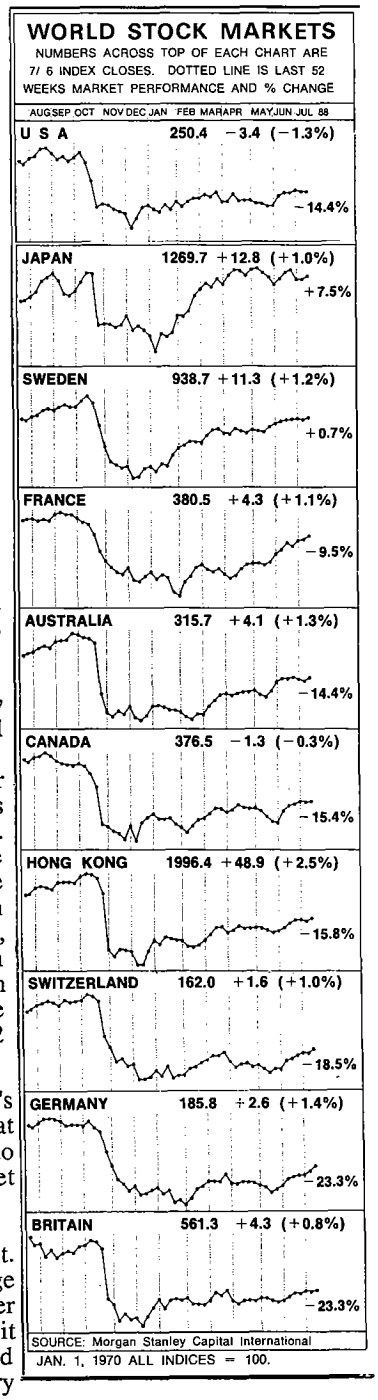
When bear market trouble surfaces again (and it will), it's not going to come from business, which is where everyone is looking. Here are some interesting views from the latest issue of the authoritative *Bank Credit Analyst* (514-874-1894). "Higher inflation looms ahead. Inflation will reach 6% to 7% in the coming year without any change in policy. . . . The US is running out of time before capital flight problems develop. Dollar strength in 1988 has allowed central banks to slowly dump part of their massive dollar holdings and to raise their interest rates. . . . It is ironic that Japan, Germany and the UK have allowed their rates to rise whereas the US is resisting. Yet it is the US which has the most serious inflation risk and growing net foreign indebtedness. . . . Attempts by US authorities to extend the business cycle will prove short-lived. The dollar will come under attack, leading to plunging credit and equity market prices. . . . The US is at the cusp. . . . US monetary and fiscal policy has been too expansionary for too long. The economy is very near capacity threshholds, with the full inflationary impact of the dollar's devaluation yet to appear. . . . Equities remain vulnerable."

INVESTMENT POSITION: Despite what you read (even in *Barron's* "The Trader" column), this is still a bear market, and bruin remains firmly in the box. (Sorry I called the bear "toro" in the last Letter; it was probably wishful thinking, but at least I got the picture right.) I spent the whole early part of this Letter explaining why it remains a bear market despite upside confirmations -- so I hope my position is clear now.

My PTI is still in a rising trend (page 2 chart), but DowPow cannot break out of its post-crash consolidation formation, and this tells us that the rise remains sub-standard. And since this is a bear market, we continue to play it safe.

Question: You have often stated that all primary movements and most major secondary movements are international in scope. Would you explain?

Answer: I first learned of this concept from Robert Rhea's work, written back in the 1930s. But when I started writing these reports in the late-1950s it was almost impossible to find out what was happening in the overseas markets. I remember calling New York banks, brokerage houses, even Swiss banks as I tried to dig out figures on what the foreign exchanges were doing. There was just no information. I believe it was *Barron's* somewhere in the '70s that finally began publishing statistics on the major exchanges. Now the movements of the major foreign exchanges are available from many sources, and even from some daily newspapers such as the WSJ.


WORLD STOCK MARKETS
NUMBERS ACROSS TOP OF EACH CHART ARE 7/ 6 INDEX CLOSES. DOTTED LINE IS LAST 52 WEEKS MARKET PERFORMANCE AND % CHANGE
AUG SEP OCT NOV DEC JAN FEB MAR APR MAY JUN JUL 88
U S A 250.4 −3.4 (−1.3%) −14.4%
JAPAN 1269.7 +12.8 (+1.0%) +7.5%
SWEDEN 938.7 +11.3 (+1.2%) +0.7%
FRANCE 380.5 +4.3 (+1.1%) −9.5%
AUSTRALIA 315.7 +4.1 (+1.3%) −14.4%
CANADA 376.5 −1.3 (−0.3%) −15.4%
HONG KONG 1996.4 +48.9 (+2.5%) −15.8%
SWITZERLAND 162.0 +1.6 (+1.0%) −18.5%
GERMANY 185.8 +2.6 (+1.4%) −23.3%
BRITAIN 561.3 +4.3 (+0.8%) −23.3%
SOURCE: Morgan Stanley Capital International
JAN. 1, 1970 ALL INDICES = 100.

This chart from *Investor's Daily* demonstrates how coordinated the primary and secondary movements really are. In October all the major stock markets crashed or declined violently. Since then, all the markets have been in secondary corrective rises. The lower figures in each box show the 52-week change, and note that with the exception of Japan and Sweden all the stock averages are in the minus column for the past 52 weeks.

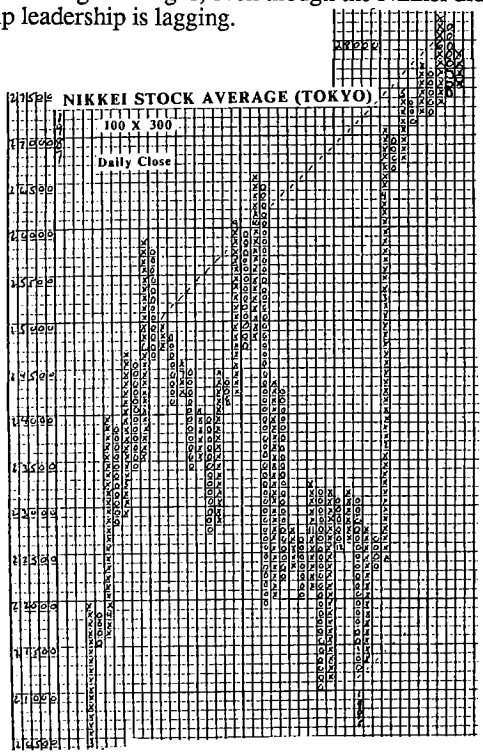
Question: I know that Japan's stock capitalization is twice that of the US. How important do you think the Japanese market really is?

Answer: Extremely important. Volume on the Tokyo Exchange is huge, frequently going over two billion shares a day. And it seems to me that the US and Japanese market are acting very much the way the British and US market acted back "in the old days." At that time the London market (the weaker of the two) would top out before the US market, and London would bottom after the US market had bottomed. My guess is that we will now see the US market top out before the Japanese market (which it did) and the stronger Japanese market will probably make its ultimate bear market bottom before the weaker US market does.

The stronger Japanese market also was much less damaged in the October crash than was the US market. And, of course, the Japanese Nikkei recently hit a new high, which the Dow and most major US averages failed to do. Like it or not, the Tokyo market is now the world leader. Furthermore, Japan is now widely accepted as an "economic superpower."

Question: You stated in the last Letter that Tokyo was finally looking weak. What would constitute a danger signal from Japan?

Answer: This point & figure chart (courtesy of *Chartcraft*, New Rochelle, NY 10801) should be helpful in pinpointing possible trouble out of Tokyo. The high for the Nikkei was recorded at 28300. I would consider a drop to 27100 a bearish signal. A further bearish signal would occur at 26600. My guess is that a top is forming here, but it will take some time. Note, by the way, that the broader Japanese stock average shown on the *Investor's Daily* chart did not surge to new highs as did the Nikkei. Thus, a non-confirmation exists, which indicates technical weakness in Tokyo. Furthermore, a long list of Japan's major corporations have not been making new highs, even though the Nikkei did, a sign that blue-chip leadership is lagging.



Question: Russell, you keep talking about this being a long, drawn-out bear market. Why do you feel that way?

Answer: I guess this is just intuitional on my part. The last great bear market, that of 1973-74, was over fairly quickly. In that bear market the Dow lost half its value and the majority of stocks lost anywhere from 50% to 90% of their values. Thus the 1973-74 bear market certainly wrung the speculation out of Wall Street, but it didn't really change the way this nation "does business." In other words, deficit spending is still rampant, the consumer is still borrowing his head off, and corporations are in many cases outrageously leveraged (as is the economy). The great American obsession, debt, was never dented, never reversed during 1973-74.

My feeling is that this bear market is going to change the way people think about debt. I believe that before this bear market is over we are going to see the debt-structure of the nation smashed. And that's going to take time. It's going to take a lot of time, because we're going to see a debt-happy US government (plus probably all our creditors) pitted against the tidal force of the primary trend. Obviously, the last thing in the world the developed nations want to see is a recession (or depression) and then a debt collapse.

It is important to remember this: debt can only be serviced (1) via taxes, borrowing, or inflation as far as governments are concerned, or (2) via earnings or profits in the case of corporations and individuals. Of course, there is a third way to "handle" debt, and that is to refinance it so that it is extended, put off to somewhere in the future.

But creditors will only hold debt if they have confidence in the debtor. It is here that I think we are going to see the big trouble, since confidence will gradually wither as the bear market drags on.

At any rate, I see a long and difficult bear market ahead, and a hint of its length can be seen in the fact that this bear market started last August, 10 months ago, and it is still in its first phase. The second phase won't begin until stocks turn down again in response to obviously deteriorating business conditions and declining corporate earnings. This may not occur until well after the election.

Question: Russell, business is still quite good, and most economists expect it to stay good. How does this jibe with the bear market thesis?

Answer: Sad to say, the upturn in business here in 1988 will only serve to extend the bear market and ultimately make it worse. I say "make it worse" because more debt has been built into the economy, move leveraged buy-outs have occurred, consumers have borrowed more, and corporate financial structures have been rendered even more fragile.

In the June 13 front-page editorial in the WSJ, Alfred Malabre Jr. posits the case for a long, tedious decline in the economy and more specifically in America's standard of living. Malabre presents the case for a bear market that "could prove so gradual, and yet so persistent, that by the time the members of the next generation are old enough to begin asking who was responsible for their diminished circumstances, they will not even know what they have lost."

Personally, I do not see the bear market being that gradual or lasting into the next century. Bear markets tend to gather steam and ferocity as they develop. Thus, my feeling is that somewhere along the line this bear market is going to trigger severe debt problems, bankruptcies (we are already seeing these in the area of the so-called thrifts), major unemployment and a good deal of pain. In the end, the way Americans think about debt and deficits is going to have to change. This, I believe, is what the bear market will be all about.

Question: What do you think is the biggest problem facing the average investor as far as handling his assets?

Answer: In my opinion, the biggest problem for the average investor in any kind of market is forming a definite plan or strategy in investing. First, they have to decide whether they are seriously interested in building up assets or whether they are just trying to "make a killing," "beat the market," or go on some sort of exciting ego trip.

This may sound ridiculous to most of my subscribers, but believe me, most people have no idea of what they're doing with their money (actually, they're usually in debt, so what they do with their money is usually pay the most pressing outstanding bills).

If the person is serious and decides that he want to build assets, then they have to develop an intelligent, workable plan -- and they must stick with that plan. As far as the trader or the thrill-seeker or the haphazard investor, I won't deal with them here since they are not serious asset-builders and sooner or later they will be knocked out of the market or drop out through sheer frustration.

But for the person who is serious about building his assets, there must be a strategy. I offer (and always have) two suggestions. The first, the safest, the surest, and the dullest is via compounding safe investments such as high-grade bonds (or even shorter-term notes). This process entails patience, discipline, persistence, and time. If you are 60 years old, forget this one, you don't have enough time. If you are 40 years of age or less, you have time on your side, and you should never, ever lose sight of the "magic" of compounding over an extended period of time.

My second suggestion is to invest with the primary trend of the stock market. This entails a good deal of study, a knowledge of Dow Theory, a thorough understanding of historic values, and plenty of intestinal fortitude (which means having the guts to sell out near the top of a bull market and having the guts to buy near the bottom of a bear market).